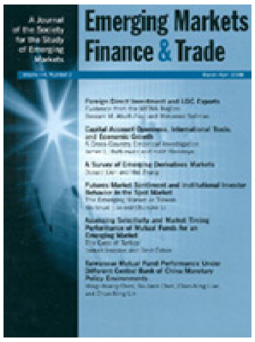

Emerging Markets Finance and Trade

ISSN: 1540-496X (Print) 1558-0938 (Online) Journal homepage: http://www.tandfonline.com/loi/mree20

Guest Editor's Introduction

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To cite this article: Bilin Neyapti (2014) Guest Editor's Introduction, Emerging Markets Finance and Trade, 50:4, 125-127, DOI: 10.2753/REE1540-496X500407

To link to this article: https://doi.org/10.2753/REE1540-496X500407

Published online: 10 Dec 2014.

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Guest Editor's Introduction

Bilin Neyapti

Globalization has made the world a smaller, though not a less complicated, place. Social, political, economic, and scientific developments diffuse across borders faster than ever, with immense effects notwithstanding individual countries' idiosyncrasies. This phenomenon was intensified by the Great Recession that spread around the world following the financial crisis in the United States. The persistent effects of this recession have sparked mass demonstrations in many developed and developing countries, and have voiced calls for improved governance and income equality. The general topic of this special section fits in such a period of a paradigm change that was precipitated by the re-recognition that markets are not a panacea for all economic ills and reforming institutions of governance is a must for sustainable development. Institutional reforms, as with any forms of technological change, however, have costs and benefits that are not distributed evenly across economic agents and generations. Reforming governance to deliver equity, therefore, stands as a great challenge facing societies in the coming decades.

The seven papers in this special section address the interplay between institutions and a wide array of developmental issues, ranging from firm performance to informality, economic growth, and foreign direct investment (FDI). Various institutional attributes of fiscal, financial, and corporate policies are addressed. The collection of papers presents a mixture of empirical evidence based on large panel data sets as well as the individual county experiences of China, Taiwan, and Turkey. Extensive literature on China's impressive growth helps reveal the reasons for the Chinese miracle and provides valuable information and possibly policy lessons for other emerging countries. It is therefore appropriate that this special section hosts two papers on the Chinese economy.

When do times of increasing uncertainty call for centralized harmonization in international policy coordination? Supranational policy harmonization via international institutions facing politico-economic uncertainty may alleviate coordination problems and the transaction costs (via, e.g., common rules, regulations, diplomatic responses, and demand management policies), but may in turn conflict with individual country circumstances. The first paper in the special section, by Baniak and Grajzl, presents a game-theoretic model to assess the conditions under which the benefits of supranational harmonization outweigh its costs. The paper's main contribution to the literature is the introduction of heterogeneity, uncertainty, and asymmetric information into the analysis. While the authors argue that asymmetries in the size and influence of jurisdictions, combined with the extent of uncertainty, affect welfare gains, they also point out the limited likelihood of instances for which ex ante centralized policy harmonization is justified. Ex ante harmonization is justified when a small jurisdiction has both greater uncertainty and substantial influence on the large jurisdiction, which is a is rare but not a totally unlikely case as the authors exemplify in the paper. This is an interesting result that also draws attention to the potential welfare gains from pursuing policy coordination in the European Union in the face of ongoing uncertainty.

The second paper is by Elgin and Oztunali, who investigate the evolution of the informal economy in relation to economic development and institutional quality. The

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Emerging Markets Finance & Trade / July–August 2014, Vol. 50, No. 4, pp. 125–127.
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ISSN 1540–496X (print)/ISSN 1558–0938 (online)
DOI: 10.2753/REE1540-496X500407

authors argue that the informal sector can be detrimental to development as it is associated with low productivity, inadequate access to finances, and scale economies. Using a dynamic general equilibrium model, they show that the informal sector starts to grow unless economic growth is associated with institutional reforms. This finding is similar in essence to the first paper in showing that economic growth needs to be accomplished by institutional reforms to prevent the former's potentially harmful effects on development. The empirical analysis utilizes a panel of 141 countries, which constitutes the largest data set on informal economy estimates reported in Elgin and Oztunali (2012). The results support the model's postulates and are robust across different measures of institution quality and informality. The authors acknowledge, however, that there is room to further explore the mechanisms whereby growth generates informality in the absence of institutional development.

The third paper, by Sun and He, argues that financial deregulation has played a significant role for FDI to generate positive effects on human capital (HC) accumulation in China. The evidence, based on a panel of provincial-level data, shows that the effect of FDI on HC can be negative below some level of financial deregulation. This suggests that FDI in the absence of financial deregulation crowds out domestic investment and hence the demand for HC; because the study covers the period from 1981 to 1999, the potential effects of labor mobility are argued to be absent. In conclusion, the large variation in the implementation of financial deregulation has led to mixed experiences in Chinese provinces. For emerging economies, the lesson emerging from this study is that an incomplete institutional reform mix may exert potentially harmful effects.

The literature provides both favorable and unfavorable arguments regarding the macroeconomic effects of fiscal decentralization (FD). Most of the recent studies of China's growth performance refer to its decentralized fiscal structure coupled with its centralized political system; nonetheless, the empirical evidence on the role of FD has been mixed. The fourth paper, by Jalil, Feridun, and Sawhney, investigates empirically the last three decades of the Chinese economy and reports that the relationship between FD and growth in China has been robust for both the short and the long run. The authors argue that the mixed evidence reported formerly may arise from the panel analyses that assume homogeneous effects of FD across the provinces. To correct for this shortcoming, the authors use the autoregressive distributed lag bounds tests to differentiate the effects of FD on the provincial level. The two other novelties utilized in the analysis are the principal components of different FD measures and the provincial-level capital stocks that are estimated by the perpetual inventory method. The paper shows that, against the potential drawbacks of FD that have been widely discussed in regard to the capacity constraints of local governments, the Chinese economy benefited from the increased efficiency in resource allocation that is facilitated by FD. The authors also note the positive contributions of trade openness and capital accumulation to this result. As in the case of the previous paper, however, the authors point at the need for the investigation of the political and institutional processes via which the positive relationship between FD and growth is achieved.

In the fifth paper, Ozkan, Balsari, and Varan investigate the series of banking-sector reforms in Turkey during the 2000s, which covers restructuring and rehabilitation of the banking sector, deposit insurance, and the revision of the banking law. The empirical analysis indicates that the reforms have had positive effects on bank lending, asset quality, and profitability; they have also shielded the Turkish economy against the destructive effects of the global financial crisis of 2007. Covering the period 1998–2009, the authors provide support for both the agency and representation hypotheses, the first of which views regulation as a corporate governance mechanism to reduce moral hazard and the second which views it as a transfer of regulatory power to the government and indirectly to minority stakeholders. The empirical findings indicate that banking reforms in Turkey have had significant positive effects on lending and asset quality, but not bank profitability. The authors caution, however, about the likelihood of non-systemic crises due to increased competition, even though the reforms have alleviated the potential of systemic crises in the banking sector.

In *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History,* North et al. (2009), lay out three doorstep conditions for limited access societies to transit into open access societies. These conditions are (1) the establishment of the rule of law among the elites, (2) the adoption of perpetually existing organizations, and (3) the political control of the military. Given the interwoven relationships between the economic and political processes, on the one hand, and the varying transitional trajectories, on the other, the sixth paper by Franke and Quintyn undertakes the difficult task of testing the validity of these conditions. Using data on ninety-three countries, the authors provide a composite index to account for the various aspects of each of the three doorstep conditions. The main political indicator is the composite index of democracy; economic indicators are gross domestic product per capita and income distribution. The empirical evidence supports the theory and demonstrates that the first doorstep possesses the greatest weight. The endogeneity of the doorstep indicators to economic performance leads the authors to use identification through heteroskedasticity method in estimation. The main findings indicate that the first two doorsteps have significant positive effects on both democratic and economic advancement, whereas the third doorstep has a positive effect on income equality. All the doorsteps, in turn, are affected positively by political and economic indicators.

The last paper in this section is different from the rest in its micro-focus, although the evidence it presents also has macroeconomic implications: institutional reforms improve firm efficiency via improved accountability and transparency. In this paper, Yeh, Chen, and Wu investigate the impact of the disclosure regime and transparency rating reforms on Taiwanese firms' earning quality attributes. The empirical findings reveal support for the significant association between both of these reforms and earning attributes.

I thank all the contributors to this issue, which benefited greatly from the valuable comments and suggestions of the referees involved. I am grateful to Ali M. Kutan, the editor of *Emerging Markets Finance & Trade,* for offering me the chance to put together this special section and for providing his valuable guidance and support throughout the process.

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